Plenary 13: Fiscal Risk Management and PPPs

Thursday, 9:00 to 10:15

CEPA

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1. Contingent liabilities

2. Contingent liability management

3. Principles and experience

4. Summary and further reading

Contingent liabilities

CEPA

- Fiscal risk management is the government's strategy to deal with issues related to contingent liabilities.
- Contingent liabilities refer to liabilities that may arise due to the occurrence of specific events in the future.
- Government contingent liabilities under a PPP programme include:
    - explicit contingent liabilities; and
    - implicit contingent liabilities.

Explicit contingent liabilities

- Explicit contingent liabilities include a wide range of formal government guarantees provided to:
    - private sector entities involved with PPPs, including banks and project vehicles (such as exchange rate and interest rate guarantees); and
    - arms-length public sectors bodies such as parastatals.
- A key feature of these liabilities is that they involve a legal obligation on the part of the government in the event that a specified event occurs.

Implicit contingent liabilities

- Implicit contingent liabilities arise where the PPP relates to infrastructure or infrastructure-related services that are strategically important – and where the government is unlikely to be able to let the PPP counter-party fail.
- These include obligations conditional upon certain events such as:
    - insuring systematic solvency of the banking system; and
    - bailing out strategically important private firms that get into financial difficulties, etc.
- Can arise through "take-or-pay" contracts where a state-owned enterprise is the counterparty to the PPP and it is refinanced to cover contractual payments.

Contingent liabilities – role of sub-national government

- Izmit Su water supply B.O.T. in Turkey signed in 1996 for 15 years.
- US$860m construction of a dam and water treatment facility for the municipality of Izmit.
- Poor preparation and lack of competition led to high fixed water charges → no one was willing to purchase water at the price.
- However the municipal government had granted a guarantee for these charges from the Treasury without their knowledge.
- Treasury was obliged to pay the contractor high fees for water that was not used. They may well have not approved the guarantee if it had knowledge of it → the Treasury should be involved in awarding projects if they have to give a guarantee!
- International arbitration proceedings were initiated in 2005.

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Contingent liability management

- Both explicit and implicit liabilities need to be appropriately managed to prevent an over-commitment on the part of the Government that it may not be typically suited to honour.
- The nature of the costs of guarantees are uncertain and could have major fiscal consequences – particularly if a large number of the risks that are guaranteed are correlated.
- Thus contingent liability management forms an integral part of the PPP policy of a country – although many countries have not yet instituted a formal policy to this effect.

An integrated approach

- Irwin (2006) recommends that governments should have an integrated policy towards guarantees, comprising allocation, valuation and management:
  - Risks under a PPP project should be allocated to those best placed to manage them. This is based on the ability of the party to influence the particular risk factor, influence the sensitivity of the total project value to the particular risk factor and absorb the risk.
  - In addition, guarantees need to be valued so as to provide a quantitative estimate of the guarantee and its impact on the total project value. If the guarantee does not substantially increase the total value of the project, its use may be in question.
  - Finally, guarantees need to be appropriately managed through suitable budgeting rules, suitable disclosure of guarantees, creation of special funds for payment of the guarantee (if called upon), etc.

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Principles and experience

- The accounting principles for contingent liabilities is a topic that has received much attention.
- Some countries do not include their contingent liabilities from PPPs on their balance sheet and hence run the risk of an over commitment and shortage of funds in the event that the guarantee is called upon.
- Efficient management of contingent liabilities requires their appropriate disclosure in the government's financial accounts.
- Incorporation of the potential future costs into medium term budgetary projections, and into an assessment of the medium-term debt sustainability is important.

International experience

- The following slides show some international examples of measures to implemented to manage contingent liabilities, including:
  - provisioning for contingent liabilities;
  - management of guarantees; and
  - reporting and disclosure of guarantees.

Provisioning for contingent liabilities

Brazil

- Established the FGP (Fundo Garantidor de Parcerias Público-Privadas), a Guarantee Fund which provides cover for financial obligations of federal government entities under PPP contracts. The Fund's assets has an upper limit of BRL6bn (approximately US$3.1bn), which are held as the guarantee of repayment for obligations under PPP contracts.

Canada

- Present value of expected fiscal cost is transferred from sectoral budget allocations to a central reserve fund.

Colombia

- Government entities providing guarantees must include estimated costs in budgets. Contributions to a centralised Contingency Fund for State Entities (FCCEE) must cover costs with 95% probability. Potential risks are reviewed annually. Each entity has accounts for each project and risk. Actual liabilities are covered up to the value of the account. Once a risk account is no longer relevant, funds are transferred into other accounts for the same project, then their other projects, only being fully released when they have no projects.

Management of guarantees

Canada

- Canada has developed a management framework for loan guarantees that requires, among others that:
    - lenders must bear a minimum of 15% of the net loss arising from a default;
    - where the government bears substantial downside risks, consideration is also given to allow parallel sharing of upside potential; and
    - Parliament sets a maximum limit on new loans and guarantees.

Chile

- Similar to Canada, in Chile, minimum revenue guarantees (and exchange rate guarantees) to operators of highways and other concessions, are partially offset by revenue sharing with the government when toll revenue is above a certain level.

Reporting and disclosure of guarantees

Chile

- Chile reports estimates of the probability weighted present value of guarantees for toll roads and airports in its annual budget documentation.

Colombia

- In Colombia, an estimate of contingent liabilities has begun to be reported annually to the Congress as part of the medium-term fiscal framework.

South Africa

- In South Africa, official medium term fiscal projections reflect expected outlays on contingent liabilities.

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Summary

- Governments have explicit and implicit guarantees.
- It is possible to put transparent processes in place to manage explicit risks.
- By their nature, implicit risks can be more difficult to manage.
- International experience shows a range of approaches, tailored to particular circumstances and accounting requirements.

Further sources

Online

1. Irwin (2006) "Public risk in private infrastructure"
   http://imf.org/external/np/seminars/eng/2006/rppia/pdf/irwin.pdf
2. Irwin (2007) "Government Guarantees: Allocating and Valuing Risk in Privately Financed Infrastructure Projects"
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3. IMF (2005) "Government Guarantees and Fiscal Risk"
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5. Castalia (2007) "Advice on Fiscal Management of Infrastructure PPPs in Pakistan: Draft Final Report to World Bank"
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